Capital Markets

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Sector: Medical Supplies & Devices

September 13, 2019

Wright Medical Group N.V.

Early AOFAS Takeaways on Hot-Button Issues

Our view: We are attending the annual AOFAS meeting in Chicago. We provide below some early takeaways on the recent issues that have led to the underperformance of WMGI shares.

Key points:

- **WMGI management lowered its 2019 Cartiva revenue guidance, attributing this to distributors.** Recall that WMGI management missed 2Q19 Cartiva sales and lowered 2019 Cartiva revenue guidance to ~$30M (from ~$47M). Management attributed the Cartiva miss to its distributor territories, where Cartiva sales were down ~40% y/y. Management suggested that these distributors stopped devoting time and resources to the product, as they did not believe they would have access to Cartiva's SCI longer-term.
- **We stick by our previous Cartiva checks and have seen mixed Cartiva study updates thus far at AOFAS.** In July 2019, we noted that our U.S. foot/ankle surgeon checks on Cartiva's SCI were less positive than 12 months prior. We also discussed a negative June 2019 retrospective chart review published by Dr. Cassinelli and colleagues. While there were limitations with the Cassinelli study, multiple foot/ankle surgeons at AOFAS agreed that they have not been able to replicate the MOTION trial results. Cartiva e-posters at AOFAS were mixed (positive e-posters from HSS and a UK hospital but a less positive study out of Texas, which pointed to Cartiva subsidence over a six-month period).
- **An ex-Cartiva distributor paints a different picture than the one outlined by WMGI management.** The recently terminated Cartiva distributor we spoke with did not agree with WMGI management's commentary on Cartiva. The distributor suggested that Cartiva sales in their region declined in 4Q18 and this continued in 1H19 due to surgeons' concerns regarding the implant. They saw subsidence issues with SCI in all types of patients, not just older patients with poor bone quality. The distributor said that their 2Q19 Cartiva sales were ~1/5 of their prior-year sales. At a 25% commission rate, the distributor was highly incentivized to sell Cartiva. The distributor noted that their Cartiva decline was due to decreased surgeon demand rather than concerns regarding the distributor's future access to the product.
- **Our checks suggest that WMGI's compensation structure was the main reason for the recent spike in its U.S. Lower Extremity sales force turnover.** WMGI management noted that its higher U.S. Lower Extremity sales rep turnover in 2Q19 was due to its reps being targeted by smaller non-public competitors. Our checks suggest that its higher U.S. Lower Extremity sales turnover was more of a company-specific issue. The ex-Cartiva distributor suggested that high-performing WMGI reps left for higher, less complicated compensation structures (straight ~15–20% commission rates) at competitors. The good news is that JNJ and SYK have moved away from a dedicated non-trauma related U.S. foot/ankle sales force, which should allow WMGI to backfill territories impacted by rep departures.

Sector Perform

NASDAQ: WMGI; USD 21.53

Price Target USD 24.00

WHAT'S INSIDE	
☐ Rating/Risk Change	☐ Price Target Change
☐ In-Depth Report	☐ Est. Change
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Scenario Analysis*

	Downside Scenario	Current Price	Price Target	Upside Scenario
Value	20.00	21.53	24.00	28.00
Return	↓7%		↑11%	↑30%

*Implied Total Returns

Key Statistics

Shares O/S (MM):	128.6	Market Cap (MM):	2,769
Dividend:	0.00	Yield:	0.0%
		Avg. Daily Volume:	3,071,028

RBC Estimates

FY Dec	2017A	2018A	2019E	2020E
Revenue	745.0	836.2	929.0	1,014.3
EPS, Adj Diluted	(0.22)	(0.02)	0.19	0.45
P/AEPS	NM	NM	NM	47.8x

Revenue	Q1	Q2	Q3	Q4
2018	198.5A	205.4A	194.1A	238.1A
2019	230.1A	229.7A	209.2E	259.9E
EPS, Adj Diluted				
2018	(0.01)A	(0.03)A	(0.09)A	0.11A
2019	0.05A	0.02A	(0.06)E	0.19E

Estimates are proforma WMGI estimates.
All values in USD unless otherwise noted.

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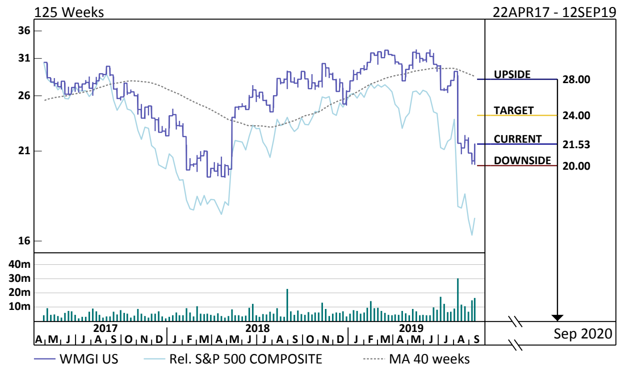
For Required Conflicts Disclosures, see Page 5.

Target/Upside/Downside Scenarios

Exhibit 1: Wright Medical Group N.V.



Source: Bloomberg and RBC Capital Markets estimates for Upside/Downside/Target

Price target/base case

Our base case price target for WMGI of $24 is based on a ~4x EV/2020E sales multiple. Our model assumes that WMGI can generate 2019 revenues of ~$929M, an increase of 12% y/y cc, and 2020 revenues of $1,014M, an increase of ~9.5% y/y cc. We assume that the company will achieve low-double-digit y/y organic topline growth in the medium term and will meet its 20%+ non-GAAP adjusted EBITDA target by the end of 2019. This analysis supports our Sector Perform rating.

Upside scenario

Our upside scenario assumes a ~4.5x 2020E EV/Sales multiple and ~$28 scenario value. We model organic top-line growth in the low-teens y/y. We assume strong AUGMENT sales in the U.S. following FDA approval of Augment Injectable as well as strong share gains in U.S. Upper Extremities and Lower Extremities. Also, we assume that Cartiva grows 20%+ y/y after recent distributor issues anniversary. Our upside scenario assumes that the company exceeds its goal of mid-20s non-GAAP adjusted EBITDA margins by the end of 2021.

Downside scenario

Our downside scenario assumes a ~3.5x 2020E EV/sales multiple and ~$20 scenario value over the next 12 months. We model organic top-line growth in the high-single-digit range y/y, in line with market growth. We assume that the U.S. ramp of AUGMENT slows, WMGI loses share in U.S. Lower Extremities, and WMGI faces increased competition in the U.S. stemless shoulders. Also, we assume the Cartiva distribution and U.S. foot/ankle rep turnover issues take longer to fix. Our downside scenario further assumes that the company falls short of its mid-20s non-GAAP adjusted EBITDA margins by the end of 2021 as management reinvests to drive topline growth.

Investment summary

We believe the shares of Wright Medical will perform in line with the peer group for the following key reasons:

We peg organic sales growth of WMGI in the low double digits, above its orthopedic peers. We note that WMGI plays in some of the faster-growing markets within orthopedics. We expect the company to grow more quickly than its end markets. To start, we believe that WMGI should be able to grow its lower extremities business in the mid-to-high single digits over the next three years, led by continued expansion of the total ankle market and new product launches, but offset by Cartiva distribution issues and higher U.S. sales force turnover. Turning to Upper Extremities, we remain excited about WMGI's new product cycle, led by the ongoing rollout of the PERFORM Reversed Glenoid and continued adoption of the SIMPLICITI shoulder. We believe WMGI's Upper Extremities business should be able to grow revenues in the low-double digits or higher over the next three years.

We are less optimistic on the longer-term market opportunity for Cartiva's SCI in great toe arthritis following our recent surgeon checks, but there is still an opportunity for WMGI to expand SCI into other indications. The company began rolling out SCI to its 350-person U.S. sales force in January 2019 (rep training completed by mid-February 2019). Additionally, WMGI bought out Cartiva's UK and Australian distributors and will be going direct in these markets in 2H19. However, foot/ankle surgeons with whom we recently spoke do not appear as positive on the SCI great toe market opportunity as they were 12 months ago. Approximately 120K great toe arthritis procedures are performed annually in the U.S., representing a market opportunity of ~$400M. Our surgeon checks estimate that the market opportunity for Cartiva is limited to ~20–30% of the great toe arthritis market.

WMGI is in the penalty box. We continue to believe that WMGI has the best-in-class product portfolio in extremities. However, we stick by our recent Cartiva surgeon checks and believe that Cartiva U.S. distribution issues will take time to fix (WMGI has terminated all but one of its Cartiva distributors). Additionally, it will take time for new U.S. direct foot/ankle sales reps to ramp. Finally, WMGI's U.S. total ankle business grew only 5% y/y in 2Q19, and we do not believe all of this weakness can be attributed to rep turnover. We believe that the total ankle market is becoming more competitive and that some INFINITY surgeons have shifted to using implants from other manufacturers (e.g., Exactech).

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Valuation

Our price target of $24 for WMGI is based on ~4x our pro-forma 2020 revenue estimate. Our target multiple is essentially in line with WMGI's SMID-cap MedTech peers growing low-double digits y/y, which are trading at ~3–5x forward EV/sales. Our proforma model assumes that WMGI can generate revenues of ~$929M (+12% y/y constant currency) and $1,014M (+9.5% y/y constant currency) in 2019 and 2020, respectively. The implied return to our price target supports our Sector Perform rating.

Risks to rating and price target

WMGI faces risks that are typical for a medical device company. The risks to our price target and rating include: M&A integration risk; increased competition; currency, litigation, reimbursement, and clinical trial risk; a prolonged economic slump (especially in Europe or the US); and navigating the FDA.

Company description

Wright Medical Group, Inc. is a global orthopedic medical device company specializing in the design, manufacture, and marketing of orthopedic devices and biologics products.

Wright Medical Group: Proforma Income Statement ($ Millions, Except Per Share Data)

	2017	1Q:18	2Q:18	3Q:18	4Q:18	2018	1Q:19	2Q:19	3Q:19E	4Q:19E	2019E	2020E
Upper Extremities	$334.7	$97.3	$99.3	$91.0	$108.2	$395.8	$111.2	$111.3	$102.4	$127.1	$452.0	$512.7
Lower Extremities	$286.5	$72.2	$75.1	$71.1	$93.1	$311.5	$86.9	$83.8	$74.2	$94.1	$338.9	$358.1
Biologics	$100.6	$23.4	$26.8	$27.2	$31.4	$108.8	$27.2	$29.9	$28.3	$33.6	$119.0	$125.4
Sports Medicine & Other	$23.2	$5.7	$4.1	$4.8	$5.5	$20.1	$4.9	$4.7	$4.3	$5.1	$19.0	$18.0
Total Revenue	$745.0	$198.5	$205.4	$194.1	$238.1	$836.2	$230.1	$229.7	$209.2	$259.9	$929.0	$1,014.3
COGS	$157.9	$40.2	$44.2	$42.9	$48.0	$175.4	$46.0	$48.0	$44.8	$53.8	$192.5	$206.1
SG&A	$525.2	$137.2	$140.8	$138.7	$153.6	$570.4	$152.9	$151.5	$146.4	$154.4	$605.2	$637.5
R&D	$49.8	$13.9	$14.7	$13.8	$16.7	$59.1	$17.0	$18.8	$17.2	$17.4	$70.3	$75.8
Amortization of Intangibles	$28.4	$7.1	$6.0	$5.9	$7.7	$26.7	$7.6	$7.9	$7.9	$7.9	$31.2	$31.4
Operating Income	-$16.3	$0.0	-$0.3	-$7.2	$12.1	$4.6	$6.7	$3.6	-$7.0	$26.4	$29.8	$63.5
Interest Expense (Income), Net	$29.4	$7.8	$8.4	$7.4	$7.4	$31.1	$7.4	$7.9	$7.9	$7.9	$31.0	$31.0
Other (Income) Expense, Net	$5.6	$0.1	$0.2	$0.2	$0.3	$0.8	$0.0	$0.6	$0.5	$0.5	$1.5	$1.6
Income Before Taxes	-$51.2	-$7.8	-$8.9	-$14.8	$4.3	-$27.3	-$0.7	-$4.8	-$15.4	$18.1	-$2.8	$30.8
Taxes	$0.1	$0.4	$0.7	$0.7	-$2.4	-$0.6	$1.1	$0.9	$0.9	$0.9	$3.7	$3.5
Tax Rate	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*	*N/M*
Net Income	-$51.2	-$8.2	-$9.6	-$15.5	$6.8	-$26.6	-$1.7	-$5.7	-$16.3	$17.2	-$6.5	$27.4
Non-GAAP Diluted Earnings Per Share	($0.49)	-$0.08	-$0.09	-$0.14	$0.05	($0.25)	-$0.01	-$0.04	-$0.12	$0.13	($0.05)	$0.21
Non-GAAP Cash Diluted Earnings Per Share	($0.22)	-$0.01	-$0.03	-$0.09	$0.11	($0.02)	$0.05	$0.02	-$0.06	$0.19	$0.19	$0.45
Wt. Avg Diluted Shares Outstanding	104.9	105.9	106.1	113.0	127.2	113.1	125.8	128.6	132.1	134.1	130.1	130.6
Margin Analysis												
COGS	21.2%	20.3%	21.5%	22.1%	20.2%	21.0%	20.0%	20.9%	21.4%	20.7%	20.7%	20.3%
Gross Margin	78.8%	79.7%	78.5%	77.9%	79.8%	79.0%	80.0%	79.1%	78.6%	79.3%	79.3%	79.7%
SG&A	70.5%	69.1%	68.6%	71.4%	64.5%	68.2%	66.4%	66.0%	70.0%	59.4%	65.1%	62.8%
R&D	6.7%	7.0%	7.1%	7.1%	7.0%	7.1%	7.4%	8.2%	8.2%	6.7%	7.6%	7.5%
Operating Income	-2.2%	0.0%	-0.2%	-3.7%	5.1%	0.5%	2.9%	1.6%	-3.4%	10.2%	3.2%	6.3%
EBITDA	11.9%	13.4%	12.5%	10.6%	18.5%	14.0%	16.3%	15.4%	12.1%	22.8%	16.9%	19.4%
Pretax Income	-6.9%	-3.9%	-4.3%	-7.6%	1.8%	-3.3%	-0.3%	-2.1%	-7.4%	7.0%	-0.3%	3.0%
Net Income	-6.9%	-4.2%	-4.7%	-8.0%	2.8%	-3.2%	-0.7%	-2.5%	-7.8%	6.6%	-0.7%	2.7%
Growth Analysis												
Upper Extremities	16.2%	24.1%	23.3%	19.8%	8.4%	18.3%	14.3%	12.1%	12.5%	17.5%	14.2%	13.4%
Lower Extremities	0.3%	4.4%	8.7%	8.8%	12.3%	8.7%	20.4%	11.5%	4.3%	1.1%	8.8%	5.7%
Biologics	7.7%	-1.6%	9.9%	14.1%	9.8%	8.1%	16.0%	11.6%	4.2%	7.0%	9.4%	5.3%
Sports Medicine & Other	0.1%	-3.2%	-26.9%	-9.8%	-13.3%	-13.3%	-14.3%	13.7%	-9.6%	-6.3%	-5.2%	-5.3%
Total Revenue	7.9%	12.0%	14.3%	13.8%	9.4%	12.2%	15.9%	11.8%	7.8%	9.1%	11.1%	9.2%
COGS	4.8%	10.4%	16.0%	15.7%	3.9%	11.1%	14.3%	8.5%	4.3%	12.1%	9.8%	7.0%
SG&A	3.8%	7.6%	10.3%	7.0%	9.5%	8.6%	11.4%	7.6%	5.6%	0.5%	6.1%	5.3%
R&D	-1.2%	11.8%	17.8%	16.5%	28.1%	18.7%	22.1%	27.9%	24.0%	4.0%	18.9%	7.8%
Operating Income	-64.3%	-100.3%	-94.0%	-52.7%	8.1%	-128.1%	33505.0%	-1185.6%	-2.2%	119.2%	551.3%	113.4%
EBITDA	64.9%	46.8%	29.3%	65.5%	16.1%	32.3%	40.3%	37.7%	22.9%	34.5%	34.5%	25.4%
Pretax Income	-28.8%	-48.7%	-37.1%	-37.6%	115.4%	-46.7%	-91.4%	-46.0%	3.9%	318.6%	-89.8%	-1204.9%
Taxes	-97.8%	-56.6%	49.2%	577.4%	67.7%	-1392.0%	153.0%	33.9%	21.6%	-135.9%	-668.0%	-4.8%
Net Income	-30.9%	-49.2%	-34.5%	-34.8%	95.4%	-48.1%	-79.1%	-40.6%	4.7%	155.0%	-75.7%	-523.4%
Non-GAAP Diluted Earnings Per Share	-31.7%	-50.3%	-35.6%	-39.5%	63.7%	-48.6%	-82.4%	-51.0%	-10.4%	141.9%	-79.1%	-496.0%
Non-GAAP Cash Diluted Earnings Per Share	-49.8%	-87.7%	-53.9%	-46.2%	17.8%	-92.8%	-546.1%	-150.0%	-25.5%	64.7%	-1273.8%	140.4%

Source: Company reports, RBC Capital Markets estimates

Required disclosures

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HOLD [Sector Perform]	588	40.80	114	19.39
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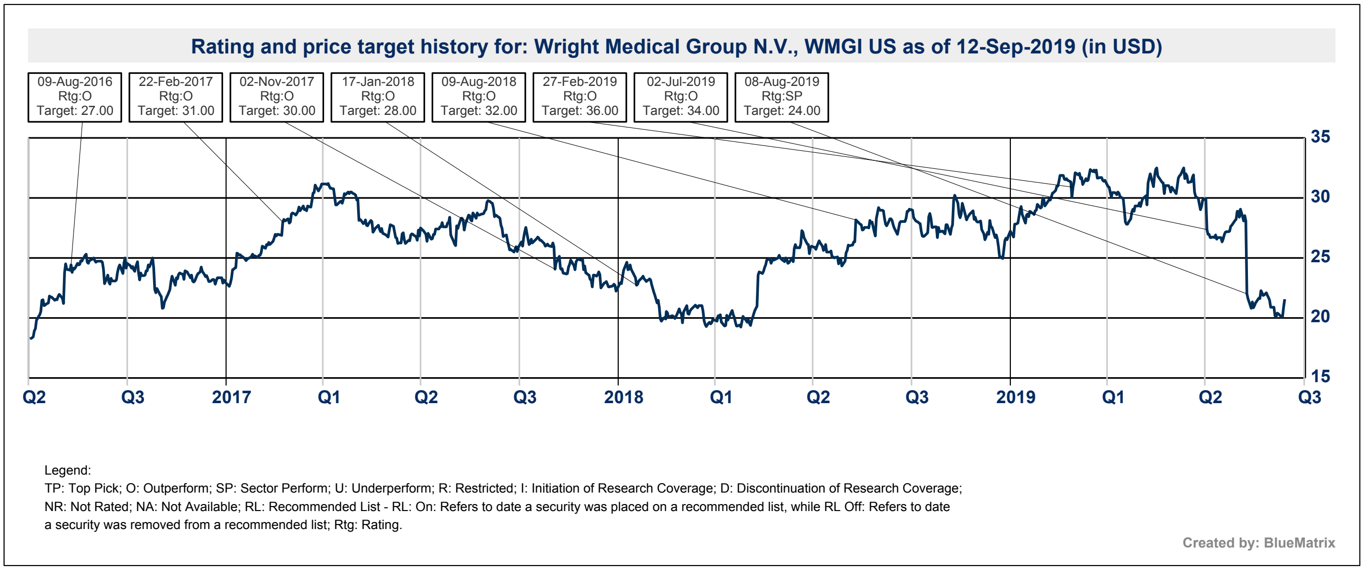

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Wright Medical Group N.V.

Valuation

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Risks to rating and price target

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